

IN THE
United States
Circuit Court of Appeals,
FOR THE NINTH CIRCUIT.

Merchants Trust Company, Trustee
of Trust No. 123-B N. S.,

Appellant,

vs.

Galen H. Welch, Collector of Internal
Revenue for the Sixth Collection
District of California,

Appellee.

BRIEF ON BEHALF OF APPELLEE.

SAMUEL W. McNABB,
United States Attorney;

IGNATIUS F. PARKER,
Assistant United States Attorney;

ALVA C. BAIRD,
929 South Broadway, Los Angeles, Cal.,
Assistant United States Attorney.

Of counsel:

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue;

EUGENE HARPOLE,
Special Attorney,
Bureau of Internal Revenue.

FILED

MAY 28 1932

PAUL P. O'BRIEN,
CLERK

TOPICAL INDEX.

	PAGE
Issue	3
Preliminary Statement.....	4
Statute and Regulations.....	5
Statement of Facts.....	7
Argument	13

TABLE OF CASES AND AUTHORITIES CITED.

	PAGE
Durfee Mineral Company, 7 B. T. A. 231.....	13
E. O. Landreth Company, 11 B. T. A. 1, 20.....	14
Maryland Casualty Company v. United States, 40 S. Ct. 155, 251 U. S. 342, p. 349; 3 A. F. T. R. 3010....	5
Revenue Act of 1928, Section 701 (a) (2).....	3, 5, 7
Revenue Act of 1928, Art. 1311.....	6
Revenue Act of 1928, Art. 1312, Sec. 701.....	6
Revenue Act of 1928, Art. 1314.....	6
Trust No. 5833, Security-First National Bank of Los Angeles, successor to Security Trust & Savings Bank, Trustee, v. Welch, 54 Fed. (2d) 323.....	4, 13

No. 6763.

IN THE
United States
Circuit Court of Appeals,
FOR THE NINTH CIRCUIT.

Merchants Trust Company, Trustee
of Trust No. 123-B N. S.,

Appellant,

vs.

Galen H. Welch, Collector of Internal
Revenue for the Sixth Collection
District of California,

Appellee.

BRIEF ON BEHALF OF APPELLEE.

Pursuant to demand made upon it by the Commissioner of Internal Revenue through his duly authorized representatives appellant paid a tax for the calendar year 1928, at the prevailing corporate rate, in the amount of \$5,712.65.

Issue.

Section 701 (a) (2) of the Revenue Act of 1928 provides:

“The term ‘corporation’ includes association, joint-stock companies, and insurance companies.”

The question is whether under the facts pertaining to the instant case the appellant comes within the purview of the foregoing section. The Government contends it is a business enterprise and, as such, falls within the category of an association, and is taxable at corporate rates. The appellant denies that it is an association and maintains that it is not subject to the tax imposed upon it.

Preliminary Statement.

Trust No. 123-B N. S., of which the Mechants Trust Company of Los Angeles is the trustee, is a typical California real estate subdivision syndicate. This court has heretofore decided that such an enterprise is an association within the meaning of the Revenue Laws of the United States and, as such, is taxable as a corporation. (Trust No. 5833, *Security-First National Bank of Los Angeles*, successor to Security Trust & Savings Bank, Trustee, *v. Welch*, 54 Fed. (2d) 323.) The latter decision was rendered during the time the instant case was pending in the District Court for the Southern District of California. In the court below the following decision was rendered:

“Judgment is ordered for defendant on authority of *Security First National Bank of Los Angeles v. Galen H. Welch*, No. 6582, decided by the U. S. Circuit Court of Appeals, Ninth Circuit, December 7, 1931.

Defendant will prepare and present findings.

Dated this 21st day of December, 1931.

GEO. COSGRAVE,
U. S. District Judge.

Filed Dec. 21, 1931.”

Statute and Regulations.

Section 13(a) of the Revenue Act of 1928 provides as follows:

“(a) Rate of Tax.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax of 12 per centum of the amount of the net income in excess of the credits against net income provided in section 26.” (Chap. 852, 45 Stat. 797; 26 U. S. C. A. 2013(a).)

As indicated above, Section 701(a)(2) provides:

“The term ‘corporation’ includes associations, joint-stock companies, and insurance companies.” (Chap. 852, 45 Stat. 878; 26 U. S. C. A. 2700(a)(2).)

As in all prior acts, the Revenue Act of 1928 provides:

“Sec. 62. The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.” (Chap. 852, 45 Stat. 810; 26 U. S. C. A. 2062.)

In passing, it may be said, it has been repeatedly held by the courts that regulations of the Commissioner of Internal Revenue, in so far as not inconsistent with express statutory provisions, have the force and effect of law.

Maryland Casualty Company v. United States, 40 S. Ct. 155, 251 U. S. 342, p. 349; 3 A. F. T. R. 3010.

Pursuant to the authority vested in him by Section 62, *supra*, and with the approval of the Secretary of the Treasury, the Commissioner has promulgated Regulations 74, relating to income tax under the Revenue Act of 1928.

The articles pertinent to the statutes here involved are as follows:

“Art. 1311. Person.—The Act recognizes four classes of persons—individuals, trusts and estates, partnerships, and corporations. Corporations include associations, joint-stock companies, and insurance companies, but not partnerships properly so called. A taxpayer is any person subject to a tax imposed by the Act.”

“Art. 1312. Association.—Associations and joint-stock companies include associations, common law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to state laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the shareholders on the basis of the capital stock which each holds, or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization. A corporation which has ceased to exist in contemplation of law but continues its business in quasi-corporate form is an association or corporation within the meaning of Section 701.”

“Art. 1314. Association Distinguished from Trust.—Where trustees merely hold property for the collection of the income and its distribution among the beneficiaries of the trust, and are not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business, and the beneficiaries have no control over the trust, although their consent may be required for the filling of a vacancy among the trustees or for a modification of the terms of the trust, no association exists, and the

trust and the beneficiaries thereof will be subject to tax as provided by Sections 161-170 and by Articles 861-891. If, however, the beneficiaries have positive control over the trust, whether through the right periodically to elect trustees or otherwise, an association exists within the meaning of Section 701. Even in the absence of any control by the beneficiaries, where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the Act."

Statement of Facts.

This case was submitted to the District Court on a written stipulation of facts together with a stipulation relative to rather voluminous documentary evidence which was made a part of the record pursuant to agreement of the parties. The sole error upon which the appellant relies here is that the "District Court erred in holding that the trust was an association within the meaning of Section 701(a)(2) of the Revenue Act of 1928".

The court adopted the facts stipulated and particularly those enumerated below, as its special findings of fact. (Findings relative to jurisdictional matters are omitted.)

"I.

H. H. Cotton, who had been engaged in the real estate business in and around the city of Los Angeles, California, for a great many years, entered into a contract with the Rodeo Land and Water Company to purchase a tract of land comprising approximately 190 acres, for the sum of \$242,314.00.

The purchase contract was transferred to the Hellman Commercial Trust & Savings Bank as trustee, and the trust was designated 123.

II.

One C. C. C. Tatum desired to purchase a portion of the land involved in Trust 123 for the purpose of subdivision and sale, and interested nineteen other persons, including H. H. Cotton, and caused the Merchants Trust Company to enter into a contract to purchase approximately $136\frac{1}{2}$ acres of the land from the Hellman Commercial Trust & Savings Bank for the sum of \$320,785.00. H. H. Cotton, as the principal beneficiary of Trust 123, approved the contract for the seller, and C. C. C. Tatum approved the contract for the buyer. The Merchants Trust Company held the purchase contract as trustee for the 20 persons interested in the enterprise. The trust was designated as Trust No. 123-B N. S. The last-named trust, a copy of which was attached to and made a part of plaintiff's complaint, was executed on the 1st day of July, 1922. The tract of $136\frac{1}{2}$ acres acquired by the Merchants Trust Company, as trustee, acting for the syndicate of 20 persons, referred to above, was located within what is now the present corporate limits of the city of Beverly Hills, California. The motivating purpose of this trust was to subdivide into city lots, improve and sell the tract, above referred to, to the profit of the beneficiaries interested therein.

III.

Both H. H. Cotton and C. C. C. Tatum were substantially interested in the trust as beneficiaries. The latter individual became exclusive sales agent for the trust, and was authorized to and did promote the enterprise of improving, subdividing and selling the property.

IV.

The amount to be paid for the one hundred thirty-six and one-half acres involved was \$320,785.00, payable in five (5) yearly installments, the first of which became due in May, 1923. All of the installments were for the sum of \$50,000.00 each, except the last and final payment, which became due on May 9, 1927, which was for the sum of \$70,785.00. All of the deferred payments bore interest from May 9, 1922, at the rate of six per cent (6%) payable semi-annually.

V.

There were associated with Mr. Tatum and Mr. Cotton in this enterprise, eighteen (18) other beneficiaries, each owning beneficial interests of from five to ten one hundred fiftieths (5 to 10/150ths).

VII.

That the Commissioner of Internal Revenue ruled that the plaintiff herein was transacting business in the form and manner ordinarily adopted by corporations, and that it constituted, during the year 1928, an association, and was taxable for said period as a corporation, and directed the trustee to file, on behalf of said trust, a return for the calendar year 1928, on Form #1120, the income tax return employed by corporations, and to pay tax on any income shown thereon at the rate of 12 per centum.

XII.

That the map indicating the lots and specifying the streets was recorded June 26, 1922. Such map was prepared in March, 1922, but the surveying of the land and the preparation of the map was paid for by this trust after its execution.

XIII.

That the minimum restrictions to be imposed upon the buyers of lots sold by this trust were fixed by

the seller of the land to this trust, namely, Hellman Commercial Trust and Savings Bank and Minna A. Newman, who was acting for H. H. Cotton.

XIV.

The beneficiaries of Trust 123-B N. S. never had a formal meeting at which they voted on any question pertaining to the business of the trust, or gave instructions to Mr. Tatum or the trustee. Mr. Tatum has remained the attorney-in-fact, and the sales agent since the inception of the trust and has superintended the development of the property and the sale of the lots during that period.

XV.

The trust never acquired more than the original lots specified and set forth in the declaration of trust.

XVI.

The trust had no specific name other than Trust 123-B N. S., given to it by the trustee on its records. It had no by-laws, seal, stationery, officers, other than the attorney-in-fact and the sales agent, and it did not have any place of business except that the trustee had its own place of business.

XVII.

In 1928 no improvements were made, no maps recorded, and no streets dedicated.

XVIII.

The trustee required any and all instructions from Mr. C. C. C. Tatum to be given in writing. Mr. Tatum conferred with, and received the approval of the trustee before making expenditures for improvement, and conferred with, and received the approval of Mr. H. H. Cotton, relative to increasing the minimum building restrictions imposed on lot purchasers.

XIX.

That the total acreage in the lots involved in Trust No. 123-B N. S. was one hundred thirty-six and one-half ($136\frac{1}{2}$) acres within the county of Los Angeles, California, all of said land now being included within the corporate limits of the city of Beverly Hills; that said lots were acquired by Trust No. 123-B N. S. for the purpose of improvement and sale of the lots in the subdivision.

XX.

Units of beneficial interests were sold to the other beneficiaries for the purpose of raising additional capital to facilitate the development, improvement and sale of the tract; all of said beneficiaries purchased said units of beneficial interests for the purpose of making a profit. The beneficiaries received certificates of beneficial interests in the form set forth in Exhibit H. The beneficiaries were entitled to and did receive, upon request, information from the trustee or the sales agent relative to the development and sale of the lots comprising the tract of land held by the trust.

XXI.

That some of said beneficial interests were sold, transferred and assigned by the holders thereof, or pledged as collateral security for the payment of money or the performance of other obligations.

XXII.

That the necessary improvement and development made on said tract by said trust consisted mainly of grading, rolling and oiling streets, constructing curbs and sidewalks, and installing a water system (including the drilling of wells) for use in the development of the tract and for the domestic use of the lot purchasers.

XXIII.

That a sales office was maintained on said tract by the sales agent, the property advertised for sale, and a force of sales agents engaged who operated under the direction of C. C. C. Tatum; that during the year 1928 the sales force was reduced to that of a tract manager, but that a continuous effort has been made from the inception of the trust, to date, to dispose of the remaining lots in the tract.

XXIV.

The evidence submitted discloses that this syndicate, known as Trust No. 123-B N. S., was, during the taxable year 1928, engaged in business. At the inception of the trust there were six hundred eighty-five lots sold. Three of these were sold in 1928, and the trust had on hand for the purpose of sale forty-six and one-half ($46\frac{1}{2}$) lots at the close of the last-named year. *The management, control and sale of the lots was vested in the beneficiaries, and the Merchants Trust Company, as trustee, was authorized to act upon the order of the beneficiaries holding a majority of beneficial interests. The beneficiaries appointed C. C. C. Tatum 'as their and each of their attorney-in-fact to represent them in all matters affecting said buyers in connection with this trust, * * *.'* However, the trustee was authorized to act upon the exclusive order of Tatum, subject, however, to the right of the majority of holders of certificates of beneficial interests to remove Tatum as attorney-in-fact. In addition to the initial investment by the holders of certificates of beneficial interests, two assessments were made for the purpose of defraying outstanding obligations, amounting to the sums of \$17,499.27 and \$75,000.99, respectively. For the purpose of making these assessments assessment notices were sent to the certificate holders. A

copy of the form of notice used for this purpose was introduced in evidence as Exhibit 'T'. A distribution of the proceeds to the holders of certificates of beneficial interests, up to and including December 31, 1928, totaled \$745,900.00." (Italics ours.)

Argument.

The question of what is an association within the meaning of the Internal Revenue Laws is one that has been before this court on several different occasions. The District Court's decision in this case is based squarely on the proposition that this court's decision in Trust No. 5833, *supra*, is controlling.

In its decision in Trust No. 5833 this court pointed out:

"There are two criteria for determining whether or not an organization or combination of individuals is taxable as an association. The first test found in Article 1312 is the business test, that is to say, the test as to whether or not the organization formed 'to do business in an organized capacity' and for the distribution of profits among shareholders in proportion to the investment or shares. The second test, contained in Article 1314, is for the purpose of distinguishing an association from a trust, and depends upon the question of whether or not 'the beneficiaries have positive control over the trust, whether through the right periodically to elect trustees, or otherwise'."

It has been held that an enterprise may be an association within the meaning of the Revenue Acts, even though there is no element of control in the beneficiaries. Two of the outstanding cases involving the association question which have been before the United States Board of Tax Appeals are the cases of *Durfee Mineral Company*, 7 B.

T. A. 231, and *E. O. Landreth Company*, 11 B. T. A. 1, 20. In the former the element of control was present. In the latter the beneficiaries had no control. Both were held to be associations. However, in the instant case, as in that of Trust No. 5833, the beneficiaries have control over the trust and it is an enterprise formed "to do business in an organized capacity". All elements necessary to comply with the so-called "control test" and the "business enterprise test" are found in Trust No. 123-B N. S.

It is clear that under the terms of the declaration of trust and from the facts found by the court that Trust No. 123-B N. S. was organized for the purpose of purchasing, subdividing, improving and selling a large tract of land and that it was engaged in business for profit. In this connection, the court's attention is called to paragraphs II and XX of the court's findings of fact. Among other things, the court found:

"The motivating purpose of this trust was to subdivide into city lots, improve and sell the lots, above referred to, to the profit of the beneficiaries interested therein. * * * Units of beneficial interest were sold to the other beneficiaries for the purpose of raising additional capital to facilitate the development, improvement and sale of the tract; all of said beneficiaries purchased such units of beneficial interest for the purpose of making a profit. The beneficiaries received certificates of beneficial interest in the form set forth in Exhibit H." [Tr. 105.]

The court also found that not only during the year 1928 but from the inception of the trust to date a continuous effort has been made to dispose of the remaining lots of the tract. Paragraph XXIV of the findings of fact [Tr. 25] reads, in part, as follows:

“The evidence submitted discloses that this syndicate, known as Trust No. 123-B N. S., was, during the taxable year 1928, engaged in business.”

In Trust No. 5833 the beneficiaries were represented by and exercised control of the trust through a board of syndicate managers, who were subject to removal at their discretion. Precisely the same mode of operation was followed in the instant case. The beneficiaries here, however, chose Mr. C. C. C. Tatum as an attorney-in-fact to represent them in all matters pertaining to the trust. Tatum was subject to removal by a majority of the holders of certificates of beneficial interest. In this connection the court found:

“The management, control and sale of the lots was vested in the beneficiaries. The Merchants Trust Company, as trustee, was authorized to act upon the order of the beneficiaries holding a majority of the beneficial interests. The beneficiaries appointed C. C. C. Tatum ‘as their and each of their attorney-in-fact to represent them in all matters affecting said buyers in connection with this trust, * * *.’ However, the trustee was authorized to act upon the exclusive order of Tatum, subject, however, to the right of the majority of holders of certificates of beneficial interests to remove Tatum as attorney-in-fact.”

No extended discussion of either the facts, the law or the decided cases will be materially helpful to the court. It is deemed sufficient to call to the court’s attention that there is no material difference between this case and that of Trust No. 5833. Both cases involve typical Southern California real estate subdivision trusts. In each instance a syndicate was organized and a large tract of land was acquired for the purpose of improvement, subdivision and sale.

Mr. H. H. Cotton, one of the promoters and principal beneficiaries in Trust No. 123-B N. S., was likewise the promoter and one of the principal beneficiaries in Trust No. 5833. They were both organized for the purpose of acquiring, improving, subdividing and selling a large tract of valuable residential property. In each case capital was raised by selling units of beneficial interest to such individuals as cared to invest in the enterprise; a trust company was designated as trustee; the beneficiaries were represented in the affairs of the trust either through a board of managers or an attorney-in-fact. The instant suit was instituted prior to the time this court had rendered its decision in Trust No. 5833 and the position that counsel for the appellant is now compelled to take, namely, that there is a distinction between this case and the one heretofore decided, is, in view of the similarity of purpose and mode of operation between the two syndicates, untenable.

It is respectfully submitted that the judgment of the District Court should be sustained.

SAMUEL W. McNABB,
United States Attorney;

IGNATIUS F. PARKER,
Assistant United States Attorney;

ALVA C. BAIRD,
Assistant United States Attorney.

Of counsel:

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue;

EUGENE HARPOLE,
Special Attorney,
Bureau of Internal Revenue.